paragon review

Examining the lending market from inside out

Paragon is a specialist provider of finance, with a focus on offering buy-to-let mortgages to professional landlords and investors.

Paragon also acquires loan portfolios and provides consumer finance and specialist loan servicing for third-party clients.

With over 25 years' experience in originating, acquiring and managing loans, operating exclusively in the UK, Paragon is uniquely placed to offer a wealth of expertise, knowledge and service to our customers and investors.

Introduction

The Chancellor painted a gloomy picture of UK economic growth in his Budget statement and with a stubbornly high deficit he had limited room for manoeuvre if he was to stay the course with his Plan A.

However, some of the policies announced in the Budget should be widely welcomed:

- The Help To Buy and mortgage guarantee schemes are potentially very significant. The devil is in the detail, and there are certainly risks with the taxpayer guaranteeing high LTV mortgages, but if they successfully prompt much needed movement in the housing market we should see benefits for the construction industry and a positive effect on the wider economy.
- The commitment to consider extending the Funding for Lending (FLS) scheme is also a step in the right direction. Recent mortgage lending figures show that FLS is slowly bringing the cost of borrowing down but the Government should take this opportunity to go further and enable non-banks to use the scheme.
- Promised changes to capital and liquidity requirements for new entrants to the banking sector may not make the newspaper headlines but they have the potential to increase the availability of household and SME financing by increasing competition.

Challenges in the housing sector remain, with further spending cuts to be detailed in the June spending review and the Government's flagship welfare reform programme coming into effect. April sees both the 'bedroom tax' and Universal Credit go live and tenants will have to assume greater responsibility for their financial affairs. Government needs to manage the potential risks and ensure that vulnerable tenants' rents are paid direct to landlords if further problems are not to develop in the sector.

At a time of such great change I am looking forward to my tenure as Chairman of the Council of Mortgage Lenders (CML). Having a home is the key ingredient of a good quality of life and the wider mortgage industry needs to demonstrate its flexibility.

The CML's members account for 95% of all residential lending in the UK. Coming from a buy-to-let background, I believe will add a new dimension of thinking at the CML and I want to lead the way in demonstrating that buy-to-let mortgages play a vital role in providing private rented accommodation.

Nigel Terrington, Chief Executive

A transitional year

Last year is probably best described as **a transitional year for firms** operating in the financial services and housing markets. Wholesale funding markets continued their **rehabilitation** after the **credit crunch** while firms did their best to prepare themselves for the seemingly inevitable 'Eurogeddon'. **Looking ahead**, what does **2013** hold for us?

Housing

Predictions are split as to how the housing market will perform this year but it's likely to be similar to 2012 – moderate house price increases in London and the South East offset by declining values in the other regions.

House buying and selling will remain stable as mortgage finance remains difficult to obtain without a significant deposit. The effects of increased lender confidence and cheaper finance through Funding for Lending (FLS) may be held back a little by the tightening up of lending rules through the Mortgage Market Review and other regulatory initiatives such as the European mortgage directive. However, the FLS will still drive additional lending with the Council of Mortgage Lenders already predicting £156 billion of mortgage lending in 2013 compared to £143 billion in 2012.

The result being that the rental market will continue to grow in size and importance, with buy-to-let mortgages playing a significant role.

Finance

In finance, lenders will have to adapt to yet another year of seemingly constant regulatory change, particularly the formal creation of the Prudential Regulatory Authority and the Financial Conduct Authority (FCA) in April.

This year will also see the next stages of the development of a new regime for consumer credit regulation that will affect £270 billion in outstanding credit and approximately 50,000 firms, from sole traders to multinationals. The scale and complexity of the task for the Treasury and the FCA – to instil an effective regulatory regime without adversely affecting lending volumes – is daunting but industry will also need time to adapt to the new approach.

In many respects, 2013 will be the twin of 2012; uncertainty about the future of the Eurozone endures, economic trends from the second half of 2012 will persist, while Government, industry and consumers will continue trying to make sense of the avalanche of regulatory changes.

Housing reviews

Housing is at the **forefront** of the **policy debate**, as evidenced by reviews undertaken last year by both Labour and the Liberal Democrats together with the Scottish and Welsh administrations. In addition, the **Montague Report** on the barriers to institutional **investment** in **private rented homes**, was published.

Satisfaction levels keep rising even as the number of people living in the sector continues to increase rapidly

84% **of private renters**

are satisfied with their accommodation compared to

80% **of social renters**

Source: Communities & Local Government

In terms of the Private Rented Sector (PRS), these reviews concentrated on standards and rents. All parties are taking a balanced approach to their reviews, but it is important to ensure that the behaviour of a minority of rogue landlords does not taint the reputation of the vast majority of landlords who provide a professional service in the PRS.

Typically there are three areas of focus for improving standards across the PRS	
Licensing or registration of landlords	An increase in red tape has the potential to reduce the number of landlords willing to invest in rental properties. Fewer landlords would mean fewer properties in an already under-supplied tenure of housing in the UK. There are already over 50 Acts of Parliament and 70 sets of regulations governing the PRS which, if put to proper use, would deal with issues such as rogue landlords.
Longer tenancies	Longer tenancies may suit some tenants and indeed landlords. However, one of the main attractions of renting for tenants is the flexibility that it gives them. Caution must be taken before suggesting tenants and landlords accept longer tenancies where they are not specifically desired. There is no strong evidence that longer tenancies are even needed. In any event longer term tenancies can and have been easily accommodated within the existing market structures as long as these suit both landlord and tenant.
Encouraging greater competition among landlords by increasing housing supply	The UK has an urgent requirement for housing and the PRS is key to meeting that increasing demand. Its growth and development by private landlords should be positively encouraged.

Private Rented Sector at a glance

Paragon regularly surveys its landlord customers to gain valuable insight into how their businesses are performing

Landlords in 2013

86% think tenant demand will grow or remain stable in 2013

15% of landlords plan to purchase property this year

Source: Paragon PRS Trends survey Q4 2012

Most landlords expect to purchase the following property types during 2013

47% Flats/Maisonettes

47% Terraced houses

30% Semi-detached houses

20% Multi-unit blocks

Source: Paragon PRS Trends survey Q4 2012

Yields

Gross yield is calculated from the annual rent as a percentage of the property value. In Q4 2012 the East Midlands topped the yield table whilst the national average was 6.2%.

East Midlands	7.5%*
London (central)	7.0%
North West	6.8%
North East	6.7%*
East of England	6.5%*
South West	6.3%
West Midlands	6.2%
London (outer)	6.1%
Wales	5.6%*
Yorkshire & Humberside	5.0%*

Source: BDRC Continental commissioned by Paragon
**Small base directional only*

Tenants

On average **tenants stay in a property for 2.5 years** and 1 in 10 stay for longer than 5 years.

Tenant types

Young couples: 57%	Manual workers: 33%
Families with children: 51%	Students: 25%
Young singles: 49%	Older couples: 20%
Professionals: 48%	Retired: 18%
LHA claimants: 34%	Other benefit claimants: 17%

Source: BDRC Continental commissioned by Paragon
(Landlords were asked typically what type of tenants they have and to select all that apply.)

Availability of finance across the markets remains a talking point

Currently, there is a **great** deal of **attention** from all quarters on the **availability** of **finance.**

Contraction of finance

2012 saw the traditional consumer credit market continue to contract, with some forecasters suggesting that it has shrunk by 10%.

This contraction is not simply the effect of banks making less credit available to their customers. Consumers are also paying down their debt and are saving more than in pre-crisis times. It is expected, however, that consumer credit will experience a recovery during 2013. Although credit cards have recently lost popularity, they are expected to recover, but in the short term alternative lenders offering products such as payday loans and pawnbroking are likely to continue to take market share.

Political intervention

It is hard to envisage political intervention coming in the UK alone that will have a marked effect on the confidence dynamic that underpins established trends. The creation of a new regulatory regime for consumer credit under the Financial Conduct Authority means the exact form of regulation that will apply to lenders in the future is unclear.

Securitisation

There has been a strong resurgence in the securitisation market although the number of transactions is well below its pre-crisis level. The resurgence of securitisation is a good sign for consumers. Securitisation gives additional funding capabilities to financial institutions which in turn allows them to offer a wider range of competitively priced products to consumers.

The improving securitisation market is a sign that bond investor confidence is returning which in turn has led to lower mortgage costs.

In 2012, Paragon completed its second securitisation since the markets were closed between 2007 and 2010 (its 55th securitisation since 1987). This new financing will directly translate to an increase in lending to our buy-to-let landlord customers through our Paragon Mortgages and Mortgage Trust brands.

The great bank de-leverage

Bank de-leveraging

Banks are de-leveraging assets for a number of reasons, but the key drivers are to reduce the amount of capital they are required to hold on their balance sheets and to free up cash.

Data released in 2012 by PricewaterhouseCoopers, shows there is an estimated €1.3 trillion of European loan assets (40% of which are in the UK) that financial institutions, such as banks and other lenders, are looking to dispose of.

De-leveraging activity is currently moving at a fast pace and this is expected to continue for some time, after which it will become a more organic process at a slower pace. Banks will always have assets they want and need to sell.

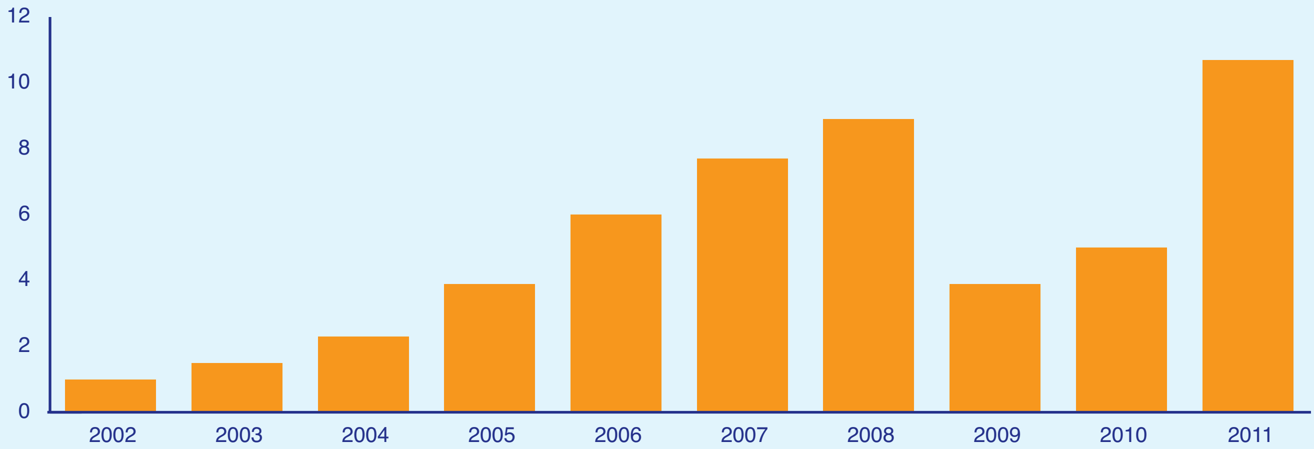
Source: PricewaterhouseCoopers

"Basel III will put additional pressure on banks to reduce capital intensive assets in their balance sheet sooner rather than later, either through a direct sale or through a structured solution aimed at reducing their RWAs."

Source: BIS

Market size

Estimates of unsecured consumer debt sale market over last 10 years



Notes:
1. Based on Ernst & Young estimates, Credit Today, company accounts, company websites, press searches
2. Data above includes some secondary market transactions (amongst debt purchasers)

Bank de-leveraging impact

Selling loans at earlier stage to maximise value (in-house collections often less effective), realising cash and reducing capital requirements

Whole business/ unit disposals

Estimated £12 billion stock of defaulted, pre-charged-off unsecured consumer debt in 2011

Up to an estimated £95 billion stock of UK retail loans deemed "non-core" in 2011

Paragon and the consumer finance market

As well as being known as an **expert** on **buy-to-let** and the UK's private rented sector, Paragon is also a **highly regarded** specialist lender of **consumer finance**.

Paragon activities in buying portfolios

- We operate a loan management service for a variety of third party clients, including banks, building societies and private equity companies
- We have purchased over £3.5 billion of loans to date
- Our debt purchase subsidiary, Idem Capital, is one of the UK's leading buyers of consumer debt
- As the banks carry out their de-leveraging programmes, Paragon is well placed to continue its portfolio acquisitions programme

Paragon activities in consumer finance

- Paragon has over 25 years of experience operating in the specialist finance sector, including both mortgages and consumer loans
- We have serviced over one million customer accounts
- We have experience of originating and servicing a wide range of consumer loan assets including car finance, point-of-sale retail finance, unsecured and secured personal loans

What happens when a loan portfolio is acquired?

Before every loan portfolio acquisition purchase we carry out a careful and detailed analysis of the portfolio through extensive due diligence. Once the portfolio is acquired, the assets are migrated onto Paragon's platform and managed by our experienced people.

The migration process involves teams from across our business in order to ensure that the customers experience a seamless transition.

Our new customers are serviced by our own teams based in the West Midlands and are available to answer any queries that they have regarding the transfer of their account.

Paragon has been servicing loan portfolios of its own assets, together with those of third party clients, for over 25 years and our people are highly experienced in helping customers with varying needs. Treating customers fairly is a core principle of our business and we have an extensive range of in-house activities for managing portfolios.

We have well established working relationships with the free debt advice sector, eg Step Change Debt Charity and Citizens Advice, to ensure that our customers can access advice when needed.

We are also members of the Finance & Leasing Association and are represented on the Money Advice Liaison Group Steering Committee and Midlands Discussion Forum.

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